QNB Economics
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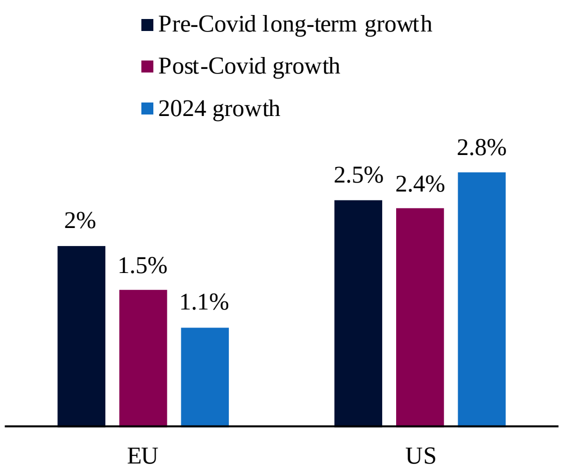
Is the European Union set for stronger growth?

The European Union (EU) has been struggling with significant headwinds from a battery of deep and broad negative economic shocks over the last few years. This included the aftermath of the pandemic, the Russo-Ukrainian conflict, the Chinese slowdown, and a lack of political cohesion for stronger policy stimulus or a bolder response to structural challenges.

While the Euro area as a whole was able to avoid a post-Covid recession, the economic bloc has been semi-stagnated, i.e., growing much below potential with several member countries, such as Germany, the Netherlands and Austria, having faced either an official recession or zero growth for a couple of quarters. Importantly, the EU is also significantly underperforming the US.

EU GDP growth decline compared with the US
(annual real GDP growth, different periods)

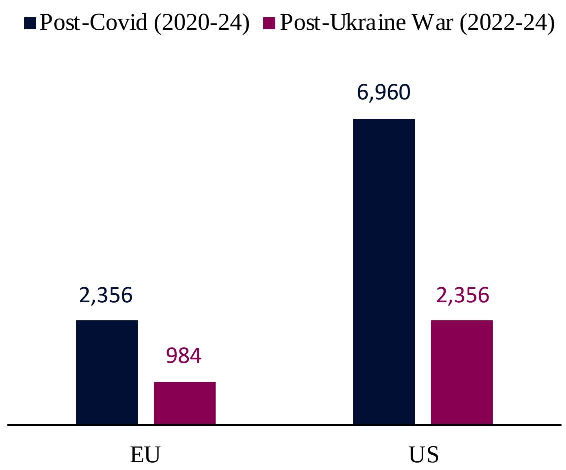


Sources: Haver, QNB analysis

Moreover, reflecting conditions from earlier this year, analysts and economists were projecting further weakness ahead for the EU, with the Bloomberg consensus still pointing to below pre-Covid pandemic long-term growth of 2%, including projections of 1.3% for 2025 and 1.5% for 2026.

However, despite the negative momentum from the previous couple of years, there is room to be more positive about European growth over the short- and medium-term. Three main reasons support our view.

Cumulated net fiscal injection into the economy
(primary deficits, USD Bn, different periods)



Sources: Haver, QNB analysis

First, negative political and geopolitical events, such as the emergence of radical political parties and disputes within the Atlantic alliance with the US, created a "burning platform" that is requiring extraordinary fiscal actions from political leaders. In Germany, Friedrich Merz, leader of the new coalition government, aims to leverage most of the German mainstream political parties to flexibilize strict budget rules and enable the approval of a massive programme for defence and infrastructure spending, which still requires constitutional amendments. This was also followed by a parallel movement at the EU level to expand the supranational EU budget and to allow member states to increase significantly their defence expenditures without triggering the "Excessive Deficit Procedure," unlocking more than EUR 800 Bn in five years under the "ReArm Europe" slogan. Such actions point to a massive change in fiscal policy stance within the EU, from restrictive to stimulative, suggesting a meaningful boost in aggregate demand and activity. A significant part of the US economic outperformance in recent years versus the EU is explained by much more accommodative fiscal policies. In fact, the US has been consistently stimulating its economy with primary deficits that are 2.5x to 3x larger than EU deficits. More fiscal flexibility in Germany and the EU should allow the bloc to stimulate more its economy while addressing the existing defence and infrastructure gaps, favouring growth.

Second, the European Central Bank (ECB) has started its easing cycle in June 2024 and is expected to enact further rate cuts this year. This comes on the back of the successful normalization of inflation and inflation expectations, which are currently running close to the 2% ECB target. The benchmark deposit facility interest rate has already been reduced by 150 basis points (bps) from a peak of 4%, and the market expects more 50 bps in cuts by the end of the year, taking the benchmark rate to 2%. Over time, this should alleviate financial conditions, lowering credit costs and favouring both investments and consumption. Therefore, regional growth should also be supported by monetary policy.

Third, European markets are pointing to a significant increase in growth expectations, expressed by the "bullish" combination of higher equity prices, higher long-term yields, and an appreciating currency. Indeed, since the beginning of the year, the STOXX 600 index of European equities is up 7.9%, while German 10-year yields are up by 50 bps and the EUR appreciated by 5.8% against the USD. This is a sign of strong investor confidence in German and EU plans to credibly boost up regional defence and, in the process, prop up growth. Equity markets, in particular, suggest positive expectations for earnings growth and a sizable improvement in business conditions. This is even more remarkable in a context where US equity indices are under pressure and the new US administration is threatening to wage a "trade war" against many competitors and allies, including the EU.

All in all, a major shift in the EU fiscal stance, alongside continued monetary easing and positive investor expectations, suggest that there is a significant upside potential for EU growth over the next few years.

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